

General Information Letter: The subtraction modification allowed partnerships for "reasonable compensation" for services rendered by partners does not necessarily allow the deduction of all income actually distributed to a partner.

March 27, 2000

Dear:

This is in response to your letter dated March 7, 2000. Given the nature of your inquiry and the information you provide, I am responding with a General Information Letter. This is not to be taken as a statement of Department policy or as a binding ruling by the Department. As general information gathered in response to your particular questions, however, I hope that it is helpful to you. See 86 Ill. Adm. Code 1200.120(b) and (c), which can be obtained at the following website:

<http://www.revenue.state.il.us/legalinformation/regs/part1200>.

In your letter you have stated the following:

I need some written direction of more detail for what should be subtracted from this line on all partnerships.

Example: Cash basis taxpayer Part 1 Line 1 is \$100,000.00,

2 partners in partnership each withdrew \$15,000.00 for the year as equal draws totaling \$30,000.00.

I believe that I should only be putting the \$30,000.00 on Line 5c. Taxpayer wants me to put \$100,000.00, because he says he could have taken that out if he wanted to.

Please supply me with written evidence to support my standing on the matter as I cannot find anything more than the instructions from the tax return booklet received from the Department.

Response

Section 201 of the Illinois Income Tax Act (IITA) imposes two separate taxes. It imposes the "regular" income tax and it also imposes a Personal Property Tax Replacement Income Tax (Replacement Tax). The regular income tax is imposed on individuals, trusts and estates at the rate of 3% of net income and on corporations at the rate of 4.8%. Section 201(b) of the IITA.

Partnerships and Subchapter S corporations are exempt from the regular tax (IITA, Sections 205(b) and 205(c)). However, partners and S-corporation shareholders are taxed directly by the income tax according to their allocated portion of income in the same manner as under the federal income tax. The Replacement Tax is imposed on corporations at the rate of 2.5% of net income and on trusts, partnerships and Subchapter S corporations at the rate of 1.5% (IITA, Section 201(d)).

Accordingly, the income of all business entities is subject to two taxes on income. Corporations pay both taxes. Partnerships and Subchapter S corporations

pay the Replacement Tax on their incomes, while the owners of these entities pay the replacement tax on their shares of the entities' incomes.

A Subchapter S corporation is allowed for federal income tax purposes to deduct salaries paid to its shareholders for personal services rendered as employees of the Subchapter S corporation, and this deduction carries over into the computation of Illinois net income (IITA Section 203(b)(1)). On the other hand, partnerships do not as a rule pay salaries to their partners for personal services rendered, and thus there is no deduction allowed for federal income tax purposes. However, in computing the net income of a partnership subject to Replacement Tax, Section 203(d)(2)(H) of the IITA allows a deduction for:

(H) Any income of the partnership which constitutes personal service income as defined in Section 1348(b)(1) of the Internal Revenue Code (as in effect December 31, 1981) or a reasonable allowance for compensation paid or accrued for services rendered by partners to the partnership, whichever is greater;

This deduction is taken on line 5c of Part I of the Form IL-1065.

The IITA does not prescribe any particular method of determining a "reasonable allowance" for compensation for services. A method which was considered reasonable in a prior administrative letter (Letter No. IT 98-0036 GIL, April 3, 1998) was to determine the number of hours each partner worked in performing personal services for the partnership during a particular year and multiplying that amount by a fair hourly wage, giving consideration to the kind of work performed.

These are matters of factual interpretation and it is not possible to provide a definitive legal opinion on them. An official determination could only be made upon an audit or during a hearing in which all relevant facts are presented and considered. However, it can be concluded in answer to your question that this amount need not be limited to the actual compensation the partners took during the year.

Please do not hesitate to call me at (217) 782-2844 if you have further questions. As stated above, this is a general information letter that does not constitute a statement of policy that applies, interprets or prescribes tax law. It is not binding on the Department as a definitive statement of tax law, but I do hope that it provides the guidance requested.

Sincerely,

Kent R. Steinkamp
Staff Attorney -- Income Tax